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PARTNERSHIP SINCE 1590

MACRO NEWS 31/12/2018

Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

AS 2018 DRAWS TO A CLOSE...

Berenberg Macro Flash

...markets are torn between recession fears and the hope that it is just another false alarm. As the saying goes, financial markets tend to predict nine out of five recessions. For economists, it is probably the other way around, though. Economic fundamentals remain mostly positive. What we may have to fear for 2019 is fear itself and the risk of extraordinary political stupidity well beyond the usual mishaps of life.

THE FEAR FACTOR

Economic logic suggests that 2019 is still a few years too early for a recession. In the long but mostly shallow upswing since the great financial crisis, we have not thrown much of an economic party yet outside pockets of some financial markets (US tech?, US energy sector bonds?). We thus have little reason for a bad hangover. What could get us down nonetheless is the fear factor. If we all worry more than is justified, we may collectively spend too little, frightening ourselves into a downturn. On a small scale, we have seen the beginnings of such self-reinforcing downside dynamics in the Eurozone in late 2018. The series of external shocks and political risks has started to seep into domestic demand. In the US, the risk has risen that the equity market correction, political gridlock and the fading of the tax-cut stimulus may jointly deal a serious blow to confidence. Tellingly, the US itself, rather than Europe or Asia, has been a focus in the most recent equity market sell-off.

Still, it would take a big fear factor to really derail rather than just temporarily dampen the economic cycle. Fundamentals remain solid enough, central banks can serve as the buffer against any unexpectedly sharp loss of momentum if need be. Fiscal policy is likely to be neutral to marginally expansionary on both sides of the Atlantic. Gridlock can be bad – but it is also quite normal. Unless households, companies and investors panic without much of a cause, a recession driven by economic factors remains unlikely. For example, US corporate leverage could be a factor to exacerbate a recession if and when it happens for other reasons. But with good revenue growth, solid consumer fundamentals and still-low funding costs, corporate debt should itself not be a trigger for a broad downturn. That leaves the second source of concern, politics.

EXTRAORDINARY POLITICAL MISTAKES...

...would be

- for Italy’s radical government to plunge their country into a genuine Greek-style debt crisis;
- for Britain’s mostly pro-EU political class to simply let the train roll towards and then over the hard Brexit cliff instead of using the ten weeks between the likely death of May’s Brexit deal and Brexit day on 29 March 2019 to stop it through a softer Brexit option or a new vote to stay in the EU;
- for Donald Trump to hurt the US economy and impair his chances of re-election in late 2020 by going too far in his costly trade wars in 2019;

- for China to let a hard landing happen instead of using its ample policy toolbox to smooth the inevitable slowdown in cyclical momentum and trend growth.

We cannot rule out such mistakes. Still, they do not seem likely at this stage. For example, Italy's budget passed last night shows that the EU and markets have imposed some rudimentary discipline on Rome. Separately, Trump's latest musings on progress in talks with China support hopes that both sides will try to strike some deal in coming months even if some of the thorny issues between the geostrategic rivals will probably not be fully resolved for many years.

Life is full of risks. In the third year of Trump and the seventh year of Xi Jinping, the recession risk is more acute than it has been since the worst of the euro crisis in 2011/2012. Sometimes, things go badly wrong, as they did when the US decided against winding down Lehman Brothers in an orderly fashion in September 2008 and when the Eurozone decided in mid-2011 to restructure Greek public debt without providing adequate safeguards against contagion. But these are the exceptions. Usually, we collectively manage to dodge the worst risks. Chances are that, after a rocky start to the New Year, a less negative narrative can unfold later in 2019. That we have finally put an unexpectedly difficult 2018 behind us need not remain the only reason to celebrate the advent of a New Year tonight.

I wish all our readers the best of luck for 2019.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@
berenberg.com